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February 29, 2008

HAND DELIVERED

Commissioner Mike Gleason, Chairman
Commissioner William A. Mundell
Commissioner Jeff Hatch-Miller
Commissioner Kristin K. Mayes
Commissioner Gary Pierce
Arizona Corporation Commission
1200 W. Washington St.
Phoenix, AZ 85007

Arizona Corporation Commission
DOCKETED

FEB 29 2008

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Re: *Arizona Electric Power Cooperative's Request for Review of FPPCA Efficacy and Implementation of Alternate Adjustor Rates; Decision No. 68071 dated August 17, 2005 (the "Rate Case Decision"); Docket Nos. E-01773A-04-0528 and E-04100A-04-0527*

Dear Commissioners:

In the 2005 Rate Case Decision, you authorized a Fuel and Purchased Power Clause Adjustor mechanism ("FPPCA") for AEPCO. It allows semi-annual adjustments in April and October to either recover or refund changes in fuel and purchased power expense as compared to 2003 test year cost levels.¹ In approving that FPPCA, however, the Commission also stated its concern that:

AEPCO's recovery of fuel and purchased power costs under Staff's proposed FPPCA may nonetheless be outpaced by the rate of future fuel and purchased power cost increases. Therefore, we will approve the FPPCA on the terms agreed to by the parties, but in so doing, we will attach an additional condition allowing AEPCO to request the Commission to review the efficacy of the FPPCA when AEPCO submits any semi-annual FPPCA report...²

¹ AEPCO has filed revised adjustors using the FPPCA procedures approved in the Rate Case Decision for April 1 implementation if the Commission cannot act on this request by that date. However, AEPCO asks that the Commission approve the adjustors requested in this filing as soon as possible.

² Rate Case Decision, Finding 36, Sixth Ordering Paragraph, p. 16.

AEPCO has been concerned for some time that the FPPCA structure—in particular, its 12-month bank balance amortization/recovery feature—is not allowing it to keep pace with fuel and purchased power expenses. More particularly, the undercollected bank balances remain stubbornly high and resist reduction. Although AEPCO hoped that the situation was improving, its 2007 full-year experience demonstrated that was not the case and new purchased power contracts will cause these shortfalls to worsen later this year. Bank undercollections continue to force higher levels of short-term borrowings, increased interest costs, weakened general funds levels to support AEPCO's other cash needs, including its construction program, and reduced margin and equity levels.

Therefore, AEPCO requests that the Commission authorize as soon as possible (1) revised adjustor rates of 14.54 mills/kWh for its all-requirements members and 13.18 mills/kWh for its partial-requirements members based on a six-month bank amortization method and (2) continued use of the six-month method until the FPPCA can be re-examined in AEPCO's 2009-2010 rate case. A three-page exhibit supporting these revised adjustors is attached as Exhibit A.

These revised adjustors are only about two mills higher than the adjustors stated in the standard filing. Assuming average electricity use of 750 kWh, they will increase the retail members' monthly bill by only \$1.50. However, they will have a significant positive impact on the level of recovery of AEPCO's fuel and purchased power expense, its financial health and its members' cost of service.

The primary problem with the current structure of the FPPCA is its 12-month amortization feature simply does not allow AEPCO a timely opportunity to collect past undercollections or to make substantial progress toward reducing the bank. For example, from September 2005 through December 2007, AEPCO has undercollected its fuel costs by \$51.4 million, but has only been able to recover \$45.8 million of that through adjustors. The adjustors were implemented on April 1, 2006 and on that date, the bank balance was \$7 million. At the end of 2007—despite four adjustors—the bank balance was at \$5.6 million, i.e., only \$1.4 million less than when the FPPCA was activated almost two years ago.

The interest expense associated with financing these persistent undercollections continues to mount. In 2006 and 2007, the Cooperative incurred more than \$1.3 million in additional interest expense just to finance the bank. That increased expense produces a higher cost of service, obviously reduces the Cooperative's margins and restricts its ability to build equity. As mentioned previously, it also continues to drive increased short-term borrowings and consumes cash needed for other Cooperative general funds-supported projects.

By moving from a 12-month to a six-month bank amortization method, the balances will not be eliminated, but they will be reduced considerably. For example, forecasts indicate that the shorter bank recovery period will produce a \$6.6 million dollar undercollection in September,

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whereas the current method would result in a \$9.4 million undercollection.³ By March of next year, use of the six- rather than 12-month amortization method is expected to produce a bank undercollection of \$8.2 million—which, while high, is still more than \$4 million less than the bank balance level if the current method remains in use.

Finally, it is particularly important to shift to the revised bank collection method now, because new purchased power contracts will be used starting in May to meet the members', and their retail members', summer peaking needs. Although these new contracts were the best, most economic transactions produced by AEPCO's RFP solicitation process, they are approximately 18% higher in cost than the contracts used last year.⁴ Further, AEPCO's coal commodity and transport contracts are expiring at year's end. Indications are that both commodity and rail costs will increase substantially. These increased costs will, of course, drive higher FPPCA bank balances. By shifting to the shorter amortization period now, the size of those balances and their interest rate, cost of service, short-term borrowing pressures and other impacts will be reduced considerably.

AEPCO will assist the Utilities Division Staff in analyzing and processing this request as quickly as possible. It asks that the Commission act on this request in time to implement the revised adjustors by April 1 or as soon thereafter as possible.

Very truly yours,

GALLAGHER & KENNEDY, P.A.



By:

Michael M. Grant

MMG/plp
10421-46/1781632

Attachment

Original and 15 copies filed with Docket
Control this 29th day of February, 2008.

³ Assumes an April 1, 2008 implementation of the higher adjustors requested in this filing.

⁴ Actual power costs will depend on a number of factors, including amount of power purchased and natural gas prices.

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cc (w/attachment; delivered): Commissioner Mike Gleason
Commissioner William A. Mundell
Commissioner Jeff Hatch-Miller
Commissioner Kristin K. Mayes
Commissioner Gary Pierce
Ernest Johnson, Utilities Division
Jerry Anderson, Utilities Division
Barbara Keene, Utilities Division

EXHIBIT A

Arizona Electric Power Cooperative
6 Month Computation of All Requirements Power Cost Adjustor Rate
Twelve Months Ended December 31, 2007

All Requirements Tariff Formula - Power Cost Adjustor Rate:

$$F = (PC + BA) - \$0.001687$$

F = Adjustment factor in dollars per kWh, rounded to the nearest one-thousandth of a cent (\$0.00001)

PC = The Commission allowed pro forma fuel, purchased power and wheeling costs in dollars per kWh, rounded to the nearest one-thousandth of a cent (\$0.00001)

BA = The "Bank Account" represents allowable accumulated fuel and purchased energy costs in dollars per kWh, rounded to the nearest one-thousandth of a cent (\$0.00001) over or under collected in the past.

Computation of PC:

Pro Forma Fuel, Purchased Power and Wheeling Costs	\$24,012,213.62
All Requirements kWh sales	882,974,862
All Requirements PC - \$/kWh	<u>\$0.02719</u>

Computation of BA:

All Requirements Under Collected Balance - as of December 31, 2007	\$18,620,783.88
All Requirements Amount Recovered Through FPPCA	\$16,609,130.44
All Requirements Total Under Collected Balance - as of December 31, 2007	\$2,011,653.44
All Requirements kWh sales	476,379,069
All Requirements BA - \$/kWh	<u>\$0.00422</u>

Computation of All Requirements

Power Cost Adjustor Rate - \$/kWh

$$F = (\$ 0.02719 + \$ 0.00422) - \$ 0.01687$$

$$F = \$ 0.03141 - \$ 0.01687$$

$$F = \$ 0.01454$$

Adjustor Rate for April 1, 2008	\$0.01454
Current Adjustor Rate Effective October 1, 2007	<u>\$0.01268</u>
Increase to Adjustor Rate	<u>\$0.00186</u>

**Arizona Electric Power Cooperative
6 Month Computation of Mohave Power Cost Adjustor Rate
Twelve Months Ended December 31, 2006**

Partial Requirements Tariff Formula - Power Cost Adjustor Rate:

$$F = (PC + BA) - \$0.001603$$

F = Adjustment factor in dollars per kWh, rounded to the nearest one-thousandth of a cent (\$0.00001)

PC = The Commission allowed pro forma fuel, purchased power and wheeling costs in dollars per kWh, rounded to the nearest one-thousandth of a cent (\$0.00001)

BA = The "Bank Account" represents allowable accumulated fuel and purchased energy costs in dollars per kWh, rounded to the nearest one-thousandth of a cent (\$0.00001) over or under collected in the past.

Computation of PC:

Pro Forma Fuel, Purchased Power and Wheeling costs	\$41,113,722.37
Partial Requirements kWh sales	1,646,534,503
Partial Requirements PC - \$/kWh	<u>\$0.02497</u>

Computation of BA:

Partial Requirements Under Collected Balance - as of December 31, 2007	\$32,809,081.49
Partial Requirements Amount Recovered Through FPPCA	\$29,227,266.89
Partial Requirements Total Under Collected Balance - as of December 31, 2007	\$3,581,814.60
Partial Requirements kWh sales	845,370,213
Partial Requirements BA - \$/kWh	<u>\$0.00424</u>

Computation of Partial Requirements

Power Cost Adjustor Rate - \$/kWh

$$F = (\$0.02497 + \$0.00424) - \$0.01603$$

$$F = \$0.02921 - \$0.01603$$

$$F = \$0.01318$$

Adjustor Rate for April 1, 2008	\$0.01318
Current Adjustor Rate Effective October 1, 2007	<u>\$0.01208</u>
Increase to Adjustor Rate	<u>\$0.00110</u>

Arizona Electric Power Cooperative, Inc.

6 Month Computation of All Requirement and Partial Requirement Members Allowable Pro-Forma Fuel, Purchased Power and Wheeling Costs

Twelve Months Ended December 31, 2007

Description	State 1		State 2		Total		ARM		PRM		Total		Allocated ARM		Allocated ARM		Total ARM		Mohave		Total	
	Member Fuel Cost	Member Fuel Cost	Member Fuel Cost	Member Fuel Cost	Member Fuel Cost	Member Fuel Cost	kWh Sales	kWh Sales	kWh Sales	kWh Sales	kWh Sales	kWh Sales	State 1 Member Fuel Costs	State 2 Member Fuel Costs	State 1 Member Fuel Costs	State 2 Member Fuel Costs	Member Fuel Costs	Member Fuel Costs	Member Fuel Costs	Member Fuel Costs	Member Fuel Costs	Member Fuel Costs
January-07	\$4,104,129.89	\$	-	\$4,104,129.89	68,003,333	128,601,986	196,605,319	\$1,419,567.45	\$	\$1,419,567.45	\$2,684,562.44	\$4,104,129.89	-	-	-	-	\$1,419,567.45	\$2,684,562.44	-	-	-	-
February-07	2,878,374.93	-	-	2,878,374.93	54,584,361	111,556,499	166,140,860	\$945,668.97	-	\$945,668.97	1,932,705.96	2,878,374.93	-	-	-	-	945,668.97	1,932,705.96	-	-	-	-
March-07	3,504,850.76	-	-	3,504,850.76	59,487,137	127,367,369	186,854,506	\$1,115,806.85	-	\$1,115,806.85	2,389,043.91	3,504,850.76	-	-	-	-	1,115,806.85	2,389,043.91	-	-	-	-
April-07	4,350,043.48	-	-	4,350,043.48	58,261,493	128,607,609	186,869,102	\$1,356,243.62	-	\$1,356,243.62	2,993,799.86	4,350,043.48	-	-	-	-	1,356,243.62	2,993,799.86	-	-	-	-
May-07	5,379,995.24	-	-	5,379,995.24	74,288,948	144,640,480	218,929,428	\$1,825,584.57	-	\$1,825,584.57	3,554,410.67	5,379,995.24	-	-	-	-	1,825,584.57	3,554,410.67	-	-	-	-
June-07	6,776,223.73	-	-	6,776,223.73	91,970,521	160,390,347	252,360,868	\$2,469,530.37	-	\$2,469,530.37	4,306,693.36	6,776,223.73	-	-	-	-	2,469,530.37	4,306,693.36	-	-	-	-
July-07	9,718,094.43	-	-	9,718,094.43	101,996,114	171,420,322	273,416,436	\$3,625,268.04	-	\$3,625,268.04	6,092,826.39	9,718,094.43	-	-	-	-	3,625,268.04	6,092,826.39	-	-	-	-
August-07	9,971,834.57	-	-	9,971,834.57	98,213,315	164,325,351	262,538,666	\$3,730,372.16	-	\$3,730,372.16	6,241,462.41	9,971,834.57	-	-	-	-	3,730,372.16	6,241,462.41	-	-	-	-
September-07	6,853,574.95	-	-	6,853,574.95	82,433,458	145,836,013	228,269,471	\$2,474,986.60	-	\$2,474,986.60	4,378,588.35	6,853,574.95	-	-	-	-	2,474,986.60	4,378,588.35	-	-	-	-
October-07	4,392,511.33	-	-	4,392,511.33	65,378,205	126,111,337	191,489,542	\$1,499,687.68	-	\$1,499,687.68	2,892,823.65	4,392,511.33	-	-	-	-	1,499,687.68	2,892,823.65	-	-	-	-
November-07	3,506,329.18	-	-	3,506,329.18	58,390,986	110,590,067	168,981,053	\$1,211,603.40	-	\$1,211,603.40	2,294,725.78	3,506,329.18	-	-	-	-	1,211,603.40	2,294,725.78	-	-	-	-
December-07	2,096,458.24	-	-	2,096,458.24	69,966,991	127,087,123	197,054,114	\$744,378.65	-	\$744,378.65	1,352,079.59	2,096,458.24	-	-	-	-	744,378.65	1,352,079.59	-	-	-	-
Total	\$63,532,420.73	\$ 1,593,515.26	-	\$65,125,935.99	882,974,862	1,646,534,503	2,529,509,365	\$22,418,698.36	-	\$22,418,698.36	\$41,113,722.37	\$65,125,935.99	\$1,593,515.26	-	\$1,593,515.26	\$24,012,213.62	\$41,113,722.37	\$65,125,935.99	-	-	-	-